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PATENTS-EXCLUSIVE LICENSES-LICENSOR AND LICENSEE RELATIONSHIP- LLICENSEE'S OBLIGATIONS

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PATENTS—EXCLUSIVE LICENSES—LICENSOR AND LICENSEE RELATIONSHIP—LICENSEE'S OBLIGATIONS—Patent licensing is today, as always, a very significant part of patent law. Since royalty licenses allow a patentee to realize pecuniary benefits from his invention without yielding ownership, as he would by an assignment, they are especially attractive to an inventor who anticipates considerable commercial success for his contribution, and who does not desire to lose all control of the invention for a lump sum, the adequacy of which must be, at best, speculative. From the licensee's standpoint, it is usually advantageous to be free of competition from others also operating under the same patent monopoly, at least within a limited area, and consequently an exclusive license is to his advantage. There is no question but that an exclusive license presents various advantages to both parties, and the proportion of patent licenses which are of an exclusive nature is therefore considerable.

A peculiar relationship, however, arises between patentees and their exclusive licensees, which does not arise in the case of an ordinary nonexclusive license, and which entails certain implied obligations on the part of the exclusive licensee. The patent licensee's obligations, while established in other fields of contract-license law, have recently been questioned, and will undoubtedly be the storm center of conflicting policies for some time to come. The subject is therefore considered to be of interest, and it is the purpose of this comment to summarize the position of the courts on the matter as it has been expressed up to the present time.

I

Exclusive Patent License—Definition

It has been stated that an exclusive license without reservations is to be regarded as an assignment, despite its description or identification as a license.[1] It has also been held that an exclusive license for one state makes the licensee a grantee for that state.[2] But while all exclusive licenses are clearly not assignments, there is a definite relation between an assignment on a royalty basis and an exclusive license, and for many purposes these are treated the same.[3]

From the foregoing, and from common usage of the word, it might well be supposed that the term "exclusive," as applied to "license," is the equivalent of "sole," and, indeed, Robinson states categorically, "An exclusive license confers upon the licensee the *sole* right to make, use, or sell the invention within the area or for the purposes described."[4] The Court of Appeals for the Second Circuit, however, has carefully pointed out[5] that an "exclusive" license is not the equivalent of a "sole" license. The real criterion of an exclusive license, in the court's view, is whether or not the license carries with it the obligation of the licensor

[1] Waterman v. Mackenzie, 138 U.S. 252 at 256, 11 S.Ct. 334 (1891).

[2] Pendleton v. Ferguson, 15 Cal. (2d) 319, 101 P. (2d) 81, 45 U.S.P.Q. 371 (1940).

[3] Infra note 13. It will be obvious that the present comment relates to copyright and patent assignments on a royalty basis as well as to exclusive licenses. For some of the characteristic differences between assignments and licenses, see United States v. General Electric Co., 272 U.S. 476 at 489, 47 S.Ct. 192 (1926) and cases there cited.

[4] ROBINSON, THE LAW OF PATENTS 595 (1890); ELLIS, PATENT ASSIGNMENTS AND LICENSES, 2d ed., 928 (1943), indexes the subject as follows: "Exclusive License-Equivalency to an Assignment."

[5] Western Electric Co. v. Pacent Reproducer Corp., (2d Cir. 1930) 42 F. (2d) 116 at 119, cert. den. 282 U.S. 873, 51 S.Ct. 78 (1930). The court relied upon Radio Corp. v. Emerson, (2d Cir. 1924) 296 F. 51, wherein a license was held exclusive despite an outstanding "personal nonexclusive and nontransferrable license," and upon Gaylor v. Wilder, 10 How. (51 U.S.) 477 (1850), where the patentee retained the privilege of practicing the invention within the licensed territory, paying the licensee a royalty. In the latter case, the instrument purported to be an assignment, but was held to be "a license only," since it was not the assignment of an undivided interest or the assignment of the entire monopoly in the area "licensed." It does not appear that Justice Taney held the purported assignment to be an exclusive license, but merely "a license only." Gaylor v. Wilder, supra, at 495. On this point cf. WALKER ON PATENTS, Deller's ed., §366, p. 1462 (1937) and 1949 supplement.

not to grant or enlarge other licenses.[6] "In other words, a license is exclusive if it shuts off the competition which otherwise might thereafter emanate from the licensor."[7]

It is also to be noted that a patent license is not rendered non-exclusive merely because it exempts the United States or one of its departments from the scope thereof, since the government has a right to use or manufacture all patented inventions for a just compensation, determined by suit in the Court of Claims, under U.S.C. Title 35, section 68.[8]

It is obviously important to understand just what quantum of exclusiveness is required for a license to be deemed "exclusive" by the courts, lest a licensee, under a misconception that he is operating under a non-exclusive license, be unaware of the duties which might be incumbent upon him by virtue of the license being an exclusive one.

II

Exclusive Licensee's Obligation to Exploit the Patent

There is sound authority to the effect that an exclusive licensee must exploit the patent licensed.[9] It is stated in a leading treatise: "In the case of exclusive licenses there is considerable authority for the proposition that the licensee must use reasonable diligence or else render himself liable to have his license rescinded."[10] The theory of such a duty owing from the exclusive licensee is not at all a subtle one, since it involves nothing more than the implication of a covenant on the part of

[6] "We think this license made the defendant an exclusive licensee though it is true that the non-exclusive license to Westinghouse remained in effect. The argument that the Westinghouse license prevented the defendant from becoming an exclusive licensee does not take wholly into account the legal meaning of that term. As this court explained in Western Electric Co. v. Pacent Reproducer Corp., 2 Cir., 42 F. 2d 116, cert. denied 282 U.S. 873, 51 S.Ct. 78, 75 L. Ed. 771, it is not the equivalent of 'sole licensee.' A license can have the attributes which make it exclusive in the legal sense though it is not the only license. There may be one or more previous licenses which are non-exclusive and by contrast with the exclusive license are called bare. When this is so, the exclusive license does not, of course, cover the entire field, but it binds the licensor not to enlarge thereafter the scope of other licenses already granted or increase the number of licenses." Mechanical Ice Tray Corp. v. General Motors Corp., (2d Cir. 1944) 144 F. (2d) 720 at 725, cert. den. 324 U.S. 844, 65 S.Ct. 679 (1945).

[7] Guardino Tank Processing Corp. v. Olsson, 89 N.Y.S. (2d) 691 at 695, 81 U.S.P.Q. 318 (1949).

[8] Id. at 696. In Guardino Tank Processing Corp. v. Olsson, a license providing "such license to be exclusive within the aforesaid territory, except as to the United States Government or any department thereof. . ." was held merely expressive of what as a matter of law is a part of every agreement, in view of U.S.C. Title 35, §68. The grant to the United States was therefore found immaterial to the question of exclusiveness of the license.

[9] Ellis, PATENT ASSIGNMENTS AND LICENSES, 1st ed. (1936); 2d ed. (1943).

[10] Id. at 445 (1st ed.), 724 (2d ed.).

the licensee to work the patent in good faith to make it produce royalty income, the licensor's patent having been placed within the control of the licensee by virtue of the agreement. The implication of such a promise to exploit has been applied with uniformity to a wide variety of contracts in which the consideration for a grant of property lies in the payment of "sums of money based upon the earnings of the property transferred,"[11] and is not by any means confined to the area of patent licensing.[12] Neither is any distinction drawn between an exclusive patent license and an assignment on a royalty basis as to the application of the principle, and stipulation of a minimum royalty, which represents at least some base consideration for transfer of the property right, appears to have no relevancy to the question of a licensee's implied obligation to work the patent.[13]

[11] In re Waterson, Berlin and Snyder Co., (2d Cir. 1931) 48 F. (2d) 704 at 709.

[12] Situations wherein the courts have implied a contract to render the subject matter of the transfer productive, conveyance of the interest being in consideration of money payment based upon earnings of the property transferred, include: McIntyre v. Belcher, 14 C.B.N.S. 654, 143 E.R. 602 (1863) (sale of a medical practice for a percentage of the proceeds over a four-year period); Telegraph Dispatch and Intelligence Co. v. McLean, L.R. 8 Ch. App. 658 (1873) (sale of news agency at price to be determined from profits); Conrad v. Morehead, 89 N.C. 31 (1883) (lease of mine); Breckenridge Asphalt Co. v. Richardson, 147 Ky. 834, 146 S.W. 437 (1912) (asphalt mining on royalty basis); Pritchard v. McLeod, (9th Cir. 1913) 205 F. 24 (sale of mining claims at price based on proceeds); Ellis v. Swan, 38 R.I. 534, 96 A. 840 (1916) and Stoddard v. Illinois Improvement Co., 275 Ill. 199, 113 N.E. 913 (1916) (stone quarrying); Wood v. Lucy, Lady Duff-Gordon, 222 N.Y. 88, 118 N.E. 214 (1917) (exclusive right to commercialize dress designs); Great Lakes and St. Lawrence Transportation Co. v. Scranton Coal Co., (7th Cir. 1917) 239 F. 603 (implied promise to transport coal); Diamond Alkali Co. v. P. C. Tomson and Co., Inc., (3d Cir. 1929) 35 F. (2d) 117 (loan to construct plant to use lender's raw materials, implied promise to do business for term of loan).

Other cases involving covenants to work include: Dow v. Harkin, 67 N.H. 383, 29 A. 846 (1892) (assignment of patent on royalty basis); Brewster v. Lanyon Zinc Co., (8th Cir. 1905) 140 F. 801 (license for exploration and development of oil and gas resources); Neenan v. Otis Elevator Co., (2d Cir. 1912) 194 F. 414 (assignment of patent requiring utilization within reasonable time); Oscar Barnett Foundry Co. v. Crowe, (3d Cir. 1915) 219 F. 450 (patent license to make stokers on royalty basis); Carbo-Frost Inc. v. Pure Carbonic, Inc. (8th Cir. 1939) 103 F. (2d) 210, cert. den. 308 U.S. 569, 60 S.Ct. 83 (1939) (patent license with promise to use best efforts in promotion); The Matzka Corp. v. Kelly Dry-Juice Corp., 19 Del. Ch. 359, 168 A. 70 (1933) (implied covenant to render patented licensed food preservation process productive); De Stubner v. Microid Process, Inc., 121 W.Va. 773, 6 S.E. (2d) 777 (1939) (implied covenant to exploit patented licensed pigments); and see cases cited in Guardino Tank Processing Corp. v. Olsson, 89 N.Y.S. (2d) 691 at 696-697, 81 U.S.P.Q. 318 (1949). See also MacDowell v. Ecorse-Lincoln Park Bank, 325 Mich. 591 at 596, 38 N.W. (2d) 921 (1949); 60 A.L.R. 901.

[13] "There is no valid distinction in principle between an assignment or conveyance and the exclusive license before the court. In each the entire fate of the subject of the assignment or license is in the hands of the grantee. Nor does the provision for a minimum royalty payable whether or not the licensees actually use the patents affect the conclusion." Dwight and Lloyd Sintering Co. v. American Ore Reclamation Co., (D.C. N.Y. 1937) 44 F. Supp. 391 at 393 [citing Driver-Harris Co. v. Industrial Furnace Corp., (D.C. N.Y. 1935) 12 F. Supp. 918, and Telegraph Dispatch and Intelligence Co. v. McLean, L.R. 8 Ch. App. 658 (1873)].

Without question, the leading case on the subject is *In re Waterson, Berlin and Snyder Co.*,[14] which has been cited as authority in practically every subsequent decision on the subject. *In re Waterson* involved an assignment[15] of certain copyrights to the Berlin Company, with an agreement to pay the assignors one-third of all revenue received from mechanical reproductions less any expenses incurred, as well as to pay one cent upon each copy of the songs sold. The court held, in referring to the above royalty provisions, that "Such a provision involved an implied covenant to work the copyrights so far as reasonable under all the circumstances."[16] The court then went on to say: "In both countries,[17] where there has been a conveyance upon an agreement to pay the grantor sums of money based upon the earnings of property transferred, the courts have implied a covenant to render the subject matter of the contract productive—if the property was a mine, a covenant to mine, quarry, or drill; if it consisted of a patent or copyright, a covenant to work the patent or copyright."[18]

Subsequent decisions left little doubt that the implied covenant of the exclusive licensee was well established. *Tesra Co. v. Holland Furnace Co.*,[19] decided in 1934, admitted the doctrine but recognized an exception. The 1935 case of *Driver-Harris Co. v. Industrial Furnace Corp.*,[20] involving an assignment of patents with a minimum royalty provision, wherein the defendant failed to pay royalties in consequence of which his receiver in bankruptcy was sued for rescission by the licensor, yields the following statement: "Where a patent is sold to be paid for on a royalty basis, a condition is implied that the patent will be worked to earn the stipulated royalties."[21] *Dwight and Lloyd Sintering Co. v. American Ore Reclamation Co.*,[22] a 1937 decision, involved an exclusive license for the use of a patented ore-sintering process providing for a minimum royalty graduated over a term, together with a royalty of three cents per ton of ore processed. The court considered itself bound by the "language and reasoning" of *In re Waterson*.[23] Again, in the recent case of *Broadcast Music, Inc. v. Taylor*,[24] a New

14 (2d Cir. 1931) 48 F. (2d) 704.
15 See note 13 supra.
16 (2d Cir. 1931) 48 F. (2d) 704 at 708.
17 Referring to England and the United States.
18 (2d Cir. 1931) 48 F. (2d) 704 at 709, with citation of cases; see note 12 supra.
19 (6th Cir. 1934) 73 F. (2d) 553. This case is discussed in §IV relative to the exception.
20 (D.C. N.Y. 1935) 12 F. Supp. 918.
21 Id. at 919.
22 (D.C. N.Y. 1937) 44 F. Supp. 391.
23 Id. at 393.
24 55 N.Y.S. (2d) 94, 65 U.S.P.Q. 503 (1945).

York Supreme Court held: "One who undertakes to work property, such as a copyright on royalty arrangement, becomes obligated to work it in good faith and for the benefit of the recipient of the royalties. . . ."[25] Finally, in *Guardino Tank Processing Corp. v. Olsson,*[26] the court stated:

> "The doctrine of implied undertaking to perform fairly and in good faith appears to have been applied whenever the subject to be exploited, tangible or intangible, has been placed in [another's] exclusive possession. . . .
>
> "In the case at bar, as in the cited cases, the fate of the subject matter was placed exclusively with the licensee for the purpose of exploitation, and, consequently, there was implicit in the arrangement the obligation of the licensee reasonably to exploit and to refrain from competition."[27]

The only question mark of this entire line of decisions was presented in *Mechanical Ice Tray Corp v. General Motors Corp.,*[28] wherein the same court which decided the *Waterson* case, speaking through Judge Chase, in strong dictum commented as follows:

> "Whatever may be left of the rule of implied covenant of an exclusive licensee to exploit the licensed device in good faith rests, as the doctrine has always rested, upon the ground that not to hold the licensee to that standard of conduct would be unfair and inequitable between the parties to the license."[29]

Thus, although the latest court of appeals decision on the point expresses doubt as to the survival of the licensee's implied covenant, subsequent decisions[30] by lower New York courts, with the court of appeals decision squarely in front of them, evidence no doubt as to its existence, thus leaving the question open for re-evaluation the next time the problem appears.

III

Exclusive Licensee's Collateral Obligation to Refrain from Entering into Competition with the Licensed Patent

As a corollary to the implied promise to work the patent, there is also an implied negative covenant that the exclusive licensee will not com-

[25] Id. at 104.

[26] 89 N.Y.S. (2d) 691, 81 U.S.P.Q. 318 (1949).

[27] Id. at 696-697. See also the patent cases cited in the second paragraph of note 12, wherein the licensee's implied covenant was also found.

[28] (2d Cir. 1944) 144 F. (2d) 720.

[29] Id. at 725. See note 71 infra. The reason for doubt as to existence of such covenant is the Mercoid decision, discussed infra under §VI.

[30] The Broadcast Music [note 24 supra] and Guardino [note 26 supra] cases.

pete with the patent, a covenant which is but a specific embodiment of the generally implied covenant that neither party will interfere with the rights of the other to enjoy benefits under a contract.[31]

In the most recent case on the point,[32] a New York Supreme Court held that there was "implicit in the arrangement the obligation of the licensee reasonably to exploit and to refrain from competition." In that case the exclusive licensee for the use of patented tank-cleaning equipment on a royalty basis paid royalties for a time, but then switched partially over to a competing process. Speaking of the licensor's rights under the contract, the court said: "In the last analysis, the right to be vindicated is that of exploitation in good faith of the Olsson patent, unfettered by voluntary competition on the part of the licensee. . . ."[33]

Other decisions in point are discussed in the following section, as these, while admitting the existence of the negative covenant, found the facts of the particular case to fall without the limitations recognized to exist with regard to the scope of the licensee's implied obligations.

The *Mechanical Ice Tray* case,[34] however, also interjects a shadow of doubt into the area of the licensee's competition restraint. The court said:

> "But even though the defendant is an exclusive licensee, there is some doubt whether that part of its duty to exploit the licensed trays in good faith which involves refraining from entering into competition with them has survived in a practical sense the decision in Mercoid Corp. v. Mid-Continent Investment Co. . . ."[35]

This statement obviously goes to the very existence of the negative covenant, and is not concerned with limitations thereof, as are the cases in the next section.[36]

[31] Uproar Co. v. National Broadcasting Co., (1st Cir. 1936) 81 F. (2d) 373 at 377, cert. den. 298 U.S. 670, 56 S.Ct. 835 (1936); Manners v. Morosco, 252 U.S. 317 at 327, 40 S.Ct. 335 (1920). See also Genet v. Delaware and Hudson Canal Co., 136 N.Y. 593, 32 N.E. 1078 (1893) (implied negative covenant against negligent destruction of coal mine where lessor received royalty on coal mined); Foster v. Callaghan and Co., (D.C. N.Y. 1918) 248 F. 944 (implied negative covenant against falsely advertising competing work where publisher agreed to advertise and supply plaintiff's book for ten-year period); Parev Products Co. v. I. Rokeach and Sons, Inc., (2d Cir. 1941) 124 F. (2d) 147 (implied negative covenant not to sell second fat substitute in such a manner as to invade market of licensed fat substitute). See also Dorsey v. Oregon Motor Stages, 183 Ore. 494 at 543, 194 P. (2d) 967 (1948).

[32] Guardino Tank Processing Corp. v. Olsson, 89 N.Y.S. (2d) 691, 81 U.S.P.Q. 318 (1949).

[33] Id. at 698.

[34] (2d Cir. 1944) 144 F. (2d) 720. See note 6 supra.

[35] Id. at 725.

[36] The impact of the Mercoid case on the doctrine of licensee's implied covenants is discussed infra under §VI.

IV

Limitations on the Scope of Licensee's Obligations

Admitting the existence of the licensee's implied covenants, it would be supposed immediately that they are qualified rather than absolute, and such appears to be in fact the case. The limitations were strongly indicated in the *Waterson* case, where Judge A. Hand stated: "Such a provision involved an implied covenant to work the copyright *so far as was reasonable under the circumstances.*"[37]

This limitation of "reasonableness" has followed the development of the implied covenants up to the present, appearing in various terms in the general language cited previously, usually in context with "good faith."[38]

On the question of what is good faith, reasonable effort on the part of the licensee, *Tesra Co. v. Holland Furnace Co.*[39] is enlightening. The case involved the assignment of patent rights from Tesra to Holland with provision for royalty payment of one dollar per unit until the payment of $50,000 to Tesra. Holland had discontinued manufacturing under the agreement. After finding that the contract did not contemplate that Holland should make any particular number of units, and that the substantial down payment by Holland was not an indication that Holland was to be bound under all circumstances to pay the $50,000, the court went on to say:

> "It was contemplated that the appellee would make a good faith effort to manufacture and sell as many of the units as it could with profit. . . . The District Court found, and this finding is supported by substantial evidence, that there was an attempt on the part of the appellee in good faith to manufacture and sell the device. This is all it was obligated to do under the contract . . . and hence it is not liable for breach of the contract."[40]

While the assignee in the *Tesra* case was obviously not required, under any implied covenant, to do more than make a good faith, reasonable attempt to work the patent, which had been done, this is but a short step from saying that he is not required to meet outside competi-

[37] In re Waterson, Berlin and Snyder Co., (2d Cir. 1931) 48 F. (2d) 704 at 708.

[38] "Good faith": Broadcast Music Inc. v. Taylor, 55 N.Y.S. (2d) 691 (1949); "good faith," "reasonably": Guardino Tank Proc. Corp. v. Olsson, 89 N.Y.S. (2d) 94 (1945); "good faith": Mechanical Ice Tray Corp. v. General Motors Corp., (2d Cir. 1944) 144 F. (2d) 720.

[39] (6th Cir. 1934) 73 F. (2d) 553.

[40] Id. at 555. While both the Waterson and the Tesra cases deal with assignments rather than exclusive licenses, the applicable principle is the same in both cases. See note 13 supra.

tion with the licensed product, if it is impossible to do so with profit. The latter limitation, as a specific example of unreasonableness, has also become thoroughly engrafted as a limitation upon the doctrine of licensee's implied covenants, and, from the decided cases, appears to be the one most often relied upon by a defendant being sued upon a basis of implied covenant to work or to refrain from competition with the licensed patent.[41]

The case of *Dwight and Lloyd Sintering Co. v. American Ore Reclamation Co.*[42] is especially interesting as it involved an exclusive license on an ore-sintering process, including the right to sublicense the plaintiff's patent. The licensee induced a third party to take a license under one of its own patents rather than that of the licensor, although the process which the third party would be employing was substantially that of the licensed patent. Plaintiff urged the licensee's implied covenant as a basis of his claim to rescission and royalties. The court replied to plaintiff's contention in the following words:

> "The obligation to exploit diligently does not necessarily exclude all competition by the licensee with the licensed patent. Thorn Wire Hedge Co. v. Washburn and Moen Mfg. Co., 159 U.S. 423, 16 S.Ct. 94, 40 L. Ed. 205; Eclipse Bicycle Company v. Farrow, 199 U.S. 581, 26 S.Ct. 150, 153, 50 L. Ed. 317. In the latter case the court stated: 'Due business diligence would not require it [the assignee] to enter into a hopeless contest, and would not prevent it from avoiding such a contest by purchase' of a patent for a competing article.
>
> "These decisions make it clear that mere ownership and use of a competing patent do not necessarily in themselves constitute

[41] See Parev Products Co. v. I. Rokeach and Sons, Inc., (2d Cir. 1941) 124 F. (2d) 147, wherein the finding of an implied covenant not to vend a competing product was refused, since sale of the competing product was necessary to meet certain outside competition. The covenant implied is given in note 31 supra. As to the value of the covenant implied, query? Cf. Randall v. Peerless Motor Car Co., 212 Mass. 352, 99 N.E. 221 (1912) where a covenant to use "best effort" was construed to exclude all competition.

In Eclipse Bicycle Co. v. Farrow, 199 U.S. 581, 26 S.Ct. 150 (1905), it was held that the assignee of certain coaster brake rights was not required to pay royalty, according to the contract terms, for coaster brakes of a second type, superior to the assigned type.

Briggs v. United Shoe Manufacturing Co., 92 N.J. Eq. 277, 114 A. 538 (1920) cert. den. 254 U.S. 653, 41 S.Ct. 149 (1920) followed the Eclipse case, and held no duty on the assignee to pay the assignor royalty where the machine the assignee was producing superseded the assigned invention.

Carbo-Frost, Inc. v. Pure Carbonic, Inc., (8th Cir. 1939) 103 F. (2d) 210, cert. den. 308 U.S. 569, 60 S.Ct. 83 (1939), held that the licensor under an exclusive license to use patented "liquefiers" for converting solid carbon dioxide or "dry ice" to gas or liquid, in return for licensee's express promise to use best efforts to promote use of the liquefiers, could recover royalties for licensee's use of other liquefiers in the absence of evidence that the other liquefiers were better than, and substantially different from, the licensed device.

[42] (D.C. N.Y. 1937) 44 F. Supp. 391.

> a violation of the implied obligation to use due diligence in working the patent. Whether due diligence has been exercised is a question of fact to be determined in each case."[43]

The court then went on to specify many factors which were considered pertinent to a consideration of the question.

The *Guardino* case offers the following paragraphs relating to the competition limitation of the licensee's implied covenants:

> "The obligation to refrain from competition was not absolute, as might have been the case if there was present an express provision against any and all competition. The implied obligation to refrain from competition was subject to the condition that it be economically feasible and did not require submission to competition without reasonable chance of success."[44]

The court also stated:

> "This court is of the opinion that the defendant utilized the Wheeler system solely to evade payment of the royalty incident to the use of the Olsson system and that the use of the Wheeler system was not in anywise due to competitive conditions. The court further finds that the third-party defendants knowingly and willfully utilized the Wheeler system in competition with the Olsson system and did not exercise reasonable effort to exploit the Olsson system."[45]

Plaintiffs were therefore allowed rescission of the license agreement and an accounting for profits made by the defendant under the substitutive system with royalties to be computed thereon for the plaintiffs.

The *Mechanical Ice Tray* case,[46] however, bears closer scrutiny, both because it is the latest court of appeals decision on the point and also because of its rather unique fact situation. Plaintiff there alleged breach of the exclusive licensee's implied covenants, in that defendant had failed to exploit the licensed inventions in good faith and had manufactured and sold a competing tray.[47] After finding the license to

[43] Id. at 394. See also Thorn Wire Hedge Co. v. Washburn and Moen Mfg. Co., cited in the above quotation, where the Supreme Court refused to imply a covenant not to manufacture barbed wire under any patents except that assigned defendant by plaintiff on a royalty basis, the assignment expressly calling for defendant's reasonable diligence in supplying the demand for the patented article. Thorn Wire Hedge Co. v. Washburn and Moen Co., 159 U.S. 423 at 450, 16 S.Ct 94 (1895).

[44] 89 N.Y.S. (2d) 691 at 697-698, 81 U.S.P.Q. 318 (1949).

[45] Id. at 699.

[46] (2d Cir. 1944) 144 F. (2d) 720.

[47] The case arose on a suit for accounting and to recover royalties allegedly due under an exclusive license of certain patents on ice trays for refrigerators. Defendant originally paid royalties on types 2, 3, and 7 trays, but after an infringement suit [Mechanical Ice Tray Corp. v. Abraham and Straus, Inc., (D.C. N.Y. 1940) 31 F. Supp. 938], brought by

be exclusive,[48] and expressing doubt as to the survival of the licensee's implied covenants,[49] the court went on to discuss limitations of the covenants in the following words:

> "There is one well recognized exception to the doctrine as it has previously been applied. That is where there is outside competition which the exclusive licensee cannot meet with reasonable chance of success with the licensed article [citations omitted[50]]. If such competition comes from something not better commercially than the licensed device he must meet it by means of the latter. If he sees fit to overcome the competition by purchasing the right to make the competing article, he cannot substitute the latter for the licensed device without thereby violating his covenant to exploit so long as he retains an exclusive license. But if competition comes from a better article than the one licensed, he is under no obligation to try with no hope of success to meet it with the licensed device. Compare Parev Products Co. v. I. Rokeach & Sons, 2 Cir. 124 F. 2d. 147. Faced with such a business situation he may, if he can, obtain and exercise the right to make or use the competing article without violating any obligation to exploit under his exclusive license."[51]

plaintiff at defendant's request, General Motors was no longer required to pay royalties on types 2 and 3, as these were held to be outside the scope of the patent claims. The license provided that Mechanical would sue infringers at defendant's request, and that, if any claims were held invalid or construed, General Motors would no longer pay royalties on trays covered by the invalidated claims or on trays previously supposed to be covered by claims which were construed to exclude them.

Since claims covering type 7 tray were unaffected by the Abraham and Straus suit, defendant continued to pay royalties on this type tray. Defendant, however, developed a tray of its own, called type 4, and sold large numbers of this type. Mechanical claimed royalties were due on all sales of type 4 trays, which were alleged to be substantially identical with the type 7 tray. Type 4 was found not to be substantially identical with type 7, and hence did not infringe plaintiff's claims to the type 7 trays.

The second ground of recovery urged (breach of licensee's implied covenants) was based upon sale of the type 4 tray coupled with reduced production and sale of the type 7 tray. This ground of recovery, sustained by the trial court, was overruled by the court of appeals, on the finding that type 4 was just as similar to types 2 and 3 as it was to type 7, and did not compete with type 7 any more than with types 2 and 3. Since types 2 and 3 were without the scope of the patent claims, it was permissible for defendant to make these types, under the license agreement, and, according to the court, any substantial equivalent thereof as well. The court therefore held that the defendant was doing only what the license provided it might do, in selling type 4 trays which were substantially equivalent to types 2 and 3.

Both the majority and dissent seemed to agree on defendant's liability *if* the implied covenant was found to have been breached, but the majority felt that the license agreement did away with implied covenants as to type 4 as well as to types 2 and 3.

[48] See note 6 supra.

[49] These aspects of the case are found supra under §§II and III.

[50] See note 41 supra.

[51] (2d Cir. 1944) 144 F. (2d) 720 at 725-726. In such case the licensor probably has the remedy of rescission available, unless the court refuses to find the licensee's implied covenants. See §V infra.

While there was no evidence of even a threat of outside competition in the *Mechanical Ice Tray* case, the court nevertheless held that there had been no breach of the licensee's implied covenants, apparently on other grounds,[52] Frank, J., dissenting vigorously because of a well-founded belief that the licensee's covenant not to compete had been breached.

V

Licensor's Remedies for Breach of Licensee's Implied Obligations

It seems clear from the decided cases that adequate remedies should be available to the licensor where his exclusive licensee has failed to live up to the implied obligations arising out of such an arrangement. While a different standard is applied by the English courts,[53] the American courts appear uniformly to allow rescission of agreements which place property, such as a patent, within the exclusive control of another, such as an assignee or exclusive licensee, if the assignee or licensee has failed to render the property productive.[54] For rescission, however, the default must be such that it destroys the essential objects of the contract or results in substantial frustration thereof.[55] In this regard, delay in royalty payments for one month has been held insuffiicient ground for rescission,[56] while delay of several years has been held sufficient time to justify rescission.[57] The case is well stated by a New

[52] See note 47 supra.

[53] "The difference between the English and American decisions lies in the fact that our courts have allowed rescission where there has been a failure on the part of the grantee or assignee to act in accordance with his obligation to render the property conveyed productive, while the English courts have refused to allow it except for fraud." In re Waterson, Berlin and Snyder Co., (2d Cir. 1931) 48 F. (2d) 704 at 709.

[54] ". . . There are numerous authorities to the effect that the failure to utilize a patent and pay royalties fixed in an agreement establishes a prima facie right as between the parties to the agreement to bring an action for rescission." Driver-Harris Co. v. Industrial Furnace Corp., (D.C. N.Y. 1935) 12 F. Supp. 918 at 919.

[55] "To allow rescission, the default must be such that it 'destroys the essential objects of the contract,' Rosenwasser v. Blyn Shoes Inc., 246 N.Y. at page 346, 159 N.E. 84, 85, or it 'must be so fundamental and pervasive as to result in substantial frustration,' Buffalo Builders' Supply Co. v. Reeb, 247 N.Y. at page 175, 159 N.E. 899, 901." In re Waterson, Berlin and Snyder Co., (2d Cir. 1931) 48 F. (2d) 704 at 709.

[56] In re Waterson, Berlin and Snyder, (2d Cir. 1931) 48 F. (2d) 704 at 709. The receiver in bankruptcy of the assignee was there allowed to sell copyrights which were the subject matter of the assignment, subject to an equitable lien for royalty payments to be made by the purchaser to the assignors. The same theory could be applied in the case of an exclusive patent license, if license was transferable.

[57] "It seems to me that the case of In re Waterson, Berlin and Snyder Co. et al. . . . when examined in its entirety, is controlling upon this court in granting the right to sue. . . . The whole theory on which rescission was denied was that sufficient time had not elapsed since the royalty became due to justify rescission. In the instant case, royalties are long past due. . . .

York Supreme Court in *Broadcast Music, Inc. v. Taylor*,[58] in the following words:

"One who undertakes to work property, such as a copyright on royalty arrangement, becomes obligated to work it in good faith and for the benefit of the recipient of the royalties, as well as for his own avail. If he fails so to do, and thereby destroys the essential object of the royalty contract, rescission thereof may be decreed."[59]

While the above case mentions only rescission, there is considerable authority that an accounting may be allowed where a competing product is manufactured, used, or sold in lieu of the licensed subject matter. Thus, in *Guardino Tank Processing Corp. v. Olsson*,[60] after finding that the defendants utilized a competing system solely to evade royalty payment on the licensed system and that use of the competing system was not due to competitive conditions, the court went on to say:

"In a case such as this those liable must account not only for the proceeds of the work done with the Olsson system, but, in addition, for the proceeds of all work done with the Wheeler system as if it had been done with the Olsson system."[61]

And again:

"Their purpose . . . is to evade the use of the Olsson system in order to escape the royalty obligation under the license agreement. Obviously the breach is substantial and warrants rescission."[62]

It is apparent from the preceding case that not only rescission, or an accounting for royalties on the competing product, but both, may be allowed if justified by the facts of the particular case.[63] It is quite

"It appears . . . that a prima facie case is made . . . and the motion should be granted." Driver-Harris Co. v. Industrial Furnace Corp., (D.C. N.Y. 1935) 12 F. Supp. 918 at 920. The royalties in this case were almost three years overdue.

[58] 55 N.Y.S. (2d) 94, 65 U.S.P.Q. 503 (1945).

[59] Id. at 104.

[60] 89 N.Y.S. (2d) 691, 81 U.S.P.Q. 318 (1949).

[61] Id. at 699.

[62] Id. at 700.

[63] See also the earlier case of American Mechanical Improvement Co. v. Des Lauriers Aircraft Corp., 94 N.J. Eq. 197 at 210, 119 A. 179 (1922), where both rescission and an accounting were allowed for plaintiff in the following words: ". . . complainant is entitled to recover royalties and half profits according to the agreement, and . . . an account should be taken of the number of fans manufactured and sold, the price received therefor and the net profits made on sales, for the purpose of determining the amount due complainant."

". . . Since the agreement vests the exclusive patent rights in the defendant company for the life of the patent and provides for no method of revocation, and since the defendant company has failed to perform its part of the agreement and has ceased manufacturing and has apparently abandoned its rights thereunder, it would be inequitable to further deprive complainant of the use of the patent and there should be a decree that the agreement is null and void and is cancelled. . . ."

possible, however, for cases to arise where the licensor may desire an accounting for sales of competing products only, and not rescission, as where defendant is still producing under the exclusive license.[64]

VI

Policy Considerations in the Light of the Mercoid Case

There appear to be special considerations in favor of upholding the exclusive licensee's implied covenants. That a patent owner, as holder of a monopoly from the government, authorized by the Constitution and congressional statutes, has the right to use his invention to the exclusion of others, manufacture or produce it himself, or license others to do so is clear, but his right to suppress the patent,[65] i.e., refrain from using, manufacturing, and selling the patented subject matter and yet prevent others from doing so, has been seriously questioned.[66] While the right of a patent owner to license his patent exclusively under such conditions as to guarantee him the expected benefits of his patent has been upheld on a basis of "reasonableness,"[67] the restraint of trade imposed by an exclusive license would not appear to be reasonable if the covenant to exploit were held no longer to exist. It has been pointed out that this very doctrine of the licensee's implied covenant "cuts

[64] See Carbo-Frost, Inc. v. Pure Carbonic, Inc., (8th Cir. 1939) 103 F. (2d) 210, cert. den. 308 U.S. 569, 60 S.Ct. 83 (1939), referred to in note 41 supra, wherein an accounting for royalties on a competing product was allowed.

An accounting for royalties on a competing product was the second theory of plaintiff's case in Mechanical Ice Tray Corp. v. General Motors Corp., (2d Cir. 1944) 144 F. (2d) 720. See note 47 supra. But rescission of the license agreement was not sought, perhaps because defendant was still producing, or perhaps because plaintiff's first theory of recovery was that all of defendant's ice tray products fell within the license agreement.

For a plaintiff to ask both rescission and an accounting for sales of competing products would appear to raise the question of inconsistent theories, viz., rescission vs. affirmance, but this apparently has not been considered inconsistent by the courts, as evidenced by the cited cases.

[65] See Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. 405, 28 S.Ct. 748 (1908) recognizing a patentee's right to suppress the patent.

[66] Special Equipment Co. v. Coe, (D.C. Cir. 1944) 144 F. (2d) 497. Suppression of a patent is felt by many to be contrary to the constitutional provision that patents are for the purpose of promoting science and useful arts. U.S. Const., art. I, §8, ¶8.

[67] See Bement v. National Harrow Co., 186 U.S. 70 at 94, 22 S.Ct. 747 (1902); Manners v. Morosco, 252 U.S. 317, 40 S.Ct. 335 (1920); Interstate Circuit, Inc. v. United States, 306 U.S. 208 at 238, 59 S.Ct. 467 (1939). See also Heaton-Peninsular Co. v. Eureka Specialty Co., (6th Cir. 1896) 77 F. 288. See also United States v. General Electric Co., 272 U.S. 476, 47 S.Ct. 192 (1926).

The same factor of reasonableness has been used to uphold exclusive agency contracts: Virtue v. Creamery Package Co., 227 U.S. 8 at 37, 33 S.Ct. 202 (1913); Locker v. American Tobacco Co., (2d Cir. 1914) 218 F. 447; Pearsall Butter Co. v. F.T.C., (7th Cir. 1923) 292 F. 720; Mar-Hof Co. v. Rosenbacker, 176 N.C. 330, 97 S.E. 169 (1918).

across"[68] the suppression rule of the *Paper Bag Case*[69] in favor of the public interest, by not allowing an exclusive licensee to deprive the public of benefits of the patent.

Surely the companion covenant of the exclusive licensee, not to compete, also has as its objective the full exploitation of the patent, with consequent gain to the public, and any objection thereto as restricting the scope of operations of the licensee cannot be sound in view of the "good faith," "reasonable" and "competition" exceptions to the licensee's covenants, discussed supra under section IV. The licensee is not forced to pawn off upon the public an inferior product, since such a product could not meet competition and the licensee could not produce and sell the same with profit by a reasonable, good faith effort. Consequently, it is not obvious how the public could suffer in any way by implication of the covenant not to compete.

Nonetheless, it was strongly urged by defendant in the *Mechanical Ice Tray* case,[70] and strongly hinted by the court in that case,[71] that public policy no longer permits an exclusive licensee to be so restricted. Basis for this argument was the *Mercoid* case,[72] which struck at licenses which required the licensee to use unpatented articles to obtain the benefits of the patented device. While it is true that the licensee's covenant not to compete affects items not covered by the patent license to the extent that it *excludes* those from the licensee's exploitations unless the licensed patent cannot meet competition, the effect of this restriction is actually to *limit* the scope of the monopoly derived from the patent, *not extend* it, and to *encourage* competition between the patented subject matter and other similar subject matter rather than stifle it, incidentally ensuring to the public the full exploitation of the licensed patent. This is the exact opposite of the effect of so-called tying licenses, which extend the patent monopoly *by including* unpatented articles, *decrease* competition in the field of the unpatented articles, and may incidentally reflect inferior quality or increased price of the tied-in unpatented articles in the finished product passed on to the public. The extreme difference in result effected by the two types of license

[68] Frank, J., dissenting in Mechanical Ice Tray Corp. v. General Motors Corp., (2d Cir. 1944) 144 F. (2d) 720 at 728.

[69] Continental Paper Bag Co. v. Eastern Paper Bag Co., 210 U.S. 405, 28 S.Ct. 748 (1908).

[70] Mechanical Ice Tray Corp. v. General Motors Corp., (2d Cir. 1944) 144 F. (2d) 720.

[71] Id. at 725 and 726. Decision on the point was not considered necessary in view of the court's interpretation of the license. Id. at 725.

[72] Mercoid Corp. v. Mid-Continent Investment Co., 320 U.S. 661, 64 S.Ct. 268 (1944).

restrictions makes it difficult to conceive how the *Mercoid* decision has any application to the exclusive licensee's implied covenants.

The inconsistent position in which one finds oneself when attempting to argue that the licensee's implied covenant no longer can exist because of public policy is illustrated in the *Mechanical Ice Tray* case.[73] While the decision went off on the interpretation of the license agreement, found by the majority to allow the competition complained of by Mechanical, the dissent did not agree with the majority's interpretation of the agreement and consequently had to meet defendant's argument that the licensee's covenants no longer survived. Judge Frank disposed of this argument in short order as inconsistent, since on the one hand the licensee defendant must urge that patents should not be used to repress competition unduly,[74] while on the other hand it asserts that it may employ its license to reduce competition between the licensed patented product, machine, or process, and the product, machine, or process being used by the licensee in lieu thereof, which obviously bars the public from receiving the advantages of the exploitation of the licensed patent.[75] Not only did Judge Frank think the licensee's covenants still existed, and should have been applied in that case, the license notwithstanding, but he also met the defendant's argument that, if the licensee's covenants be held to exist, a licensee could not make or sell a competing product even where licensed under an invalid patent, by reference to *Nachtman Spring-Filled Corp. v. Kay Mfg. Co.*[76] This

[73] Mechanical Ice Tray Corp. v. General Motors Corp., (2d Cir. 1944) 144 F. (2d) 720.

[74] Referring to the implied covenant not to compete, as a repression of the licensee's competition with the licensed patent.

[75] There was not even a threat of outside competition in the Mechanical Ice Tray case, to justify defendant's failure fully to exploit the licensed patent. The competition of defendant with the licensed patent would therefore be a breach of the implied covenant not to compete, and it is this breach which would be to the public detriment since the licensed patent would not thereafter be exploited as fully as it would if the defendant's competition were excluded.

[76] (2d Cir. 1943) 139 F. (2d) 781. This case indicates, inter alia, that a licensee could question validity of a patent under which it was licensed even though the licensee had expressly covenanted not to question the patent's validity, because of the court's desire to safeguard the public interest, and apparently Judge Frank had this aspect of the case in mind. Even though the license does not impose any conditions which would be illegal if not for the patent monopoly, e.g., price-fixing conditions, it may be that the defense of invalidity may not be waived, as it is based on public policy and is in the public interest. Id. at 785-786. As to the problem of licensee's estoppel to question validity of the patent under which it is licensed, see Sola Electric Co. v. Jefferson Electric Co., 317 U.S. 173, 63 S.Ct. 172 (1942); Scott Paper Co. v. Marcalus Mfg. Co., 326 U.S. 249, 66 S.Ct. 101 (1945); Edward Katzinger Co. v. Chicago Metallic Mfg. Co., 329 U.S. 394, 67 S.Ct. 416 (1947); MacGregor v. Westinghouse Electric and Mfg. Co., 329 U.S. 402, 67 S.Ct. 421 (1947), especially the dissent in the last two cases, indicating the uncertainty which presently exists in relation to the estoppel problem.

case he considered to take care of the matter in most instances, though the situation should not often arise, since, by judicial notice, most licensees reserve the right to surrender their license, as did defendant in *Mechanical Ice Tray* case.[77] The dissent is therefore considerably more enlightening on the subject of licensee's implied covenants than the majority opinion, since Judge Frank faced the issue of their existence, while the majority did not.

Conclusion

The exclusive patent licensee's implied covenants have been asserted to exist in all of the cases found to be in point, with the exception of one, where in dictum the court expressed doubt. Adequate remedies are available to the licensor for breach of the implied covenants, when found to exist and not to have been waived by an unusual type of license agreement, which type of license would appear to be against present policy considerations. Any doubt in this area interjected by the *Mercoid* decision would appear to be the result of a misplaced application of the doctrine there set forth. Public policy favoring the exploitation of patents is strongly in favor of continued existence of the licensee's implied covenants, and this should outweigh any considerations flowing from the anomalous application of the Mercoid doctrine.

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[77] (2d Cir. 1944) 144 F. (2d) 720 at 728. Judge Frank also condemned the majority holding, based on interpretation of the license, as against public policy in offering to those interested in stifling competition a new method of suppressing a patent. Id. at 728.

Whether or not rescission would be granted to a licensor is a question which would ordinarily depend on whether or not the court held the licensee's covenants to exist, since substantial frustration could hardly be found unless the licensee had an obligation to exploit in good faith and refrain from competition with the patent. Since the majority of the court held the license agreement to do away with the implied covenants, it seems clear that rescission could not have been granted Mechanical under the majority interpretation, without reading in some very extraordinary condition. One must therefore agree with Judge Frank that the defendant had gained control over the patent with no obligation to work it, all on a basis of interpretation of the license agreement.

The question of course exists whether Mechanical had any desire to rescind, since there is no evidence that defendant stopped making licensed products completely, but only that sales of licensed products were reduced with corresponding increase in sales of the competitive items. Defendant did continue to sell licensed type 7 trays after the Abraham and Straus decision, and paid royalties on 1,440,000 between April 1, 1940 and December 1, 1942. Id. at 727.